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Financial Markets

Irving Trust

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Friday
(Noon)

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Pressures built in the money and capital markets this week under the heavy burden of forthcoming Treasury debt offerings and a firmer rate for Federal funds. The auctions started off on a bad note with the usually popular two-year note auction going poorly, producing higher yields than expected. The lack of retail demand made many market participants wonder how the longer maturities, scheduled for auction next week, would sell. In this capital market environment, did the firmer rate for Federal funds hurt or help?

A stiffer rate for Federal funds hurts the prospect for a smooth functioning auction to the extent that RP and broker loan rates move in step with Fed funds. Higher dealer financing rates discourage dealers from bidding at the Treasury auctions and from carrying securities by reducing the positive spread of long yields over short rates. Indeed, to the extent that a higher rate for Federal funds is interpreted as a tightening by the Fed, the incentive to carry securities, and risk a price drop, greatly diminishes. But even if the higher rate for Fed funds is read as a slight tightening by the monetary authorities that doesn't necessarily impair the auction process.

For some time, dating back to November in certain cases, investors have been concerned about the too rapid money growth. To them, a firmer rate for Federal funds may be a signal that the Fed really is cautiously fighting inflation, in line with Mr. Volcker's statements of last week. To the extent that this is true, it would be a positive factor from a retail investor's standpoint. Thus dealers and investors might react differently to the same developments in the Fed funds market. What is the most likely interpretation of what the Fed is doing there?

First, the Fed does not control the funds rate perfectly. Nonetheless the funds rate has been kept in a very narrow range, indicating a strong Fed presence. Although the market has faced the possibility of some "technical" factors recently, with the passing of a corporate tax payment date, that cuts both ways. With a heavy schedule of Treasury auctions, one might have expected the Fed to err on the side of greater ease to encourage dealers to carry inventory from the auctions. But this has not happened. Thus it appears that the Fed is engineering the funds rate back to or above the level of the discount rate in an effort to gain somewhat better control over the funds rate. Such a rate configuration allows the Fed to use discount window policy to underpin the rate for Fed funds. Conversely when Fed funds trade below the discount rate, the Fed has less control; during such times, the market generally is looking for still lower rates, creating the danger that the market might become too liquid, leading rates to plunge. By moving the Fed funds rate above the discount rate, the Fed gains somewhat better technical control of the market and blunts expectations that the discount rate will soon be cut. Seen in this way, the Fed has not tightened policy; it has made a more consistent and possibly enduring pattern of market rates. Any new policy move at this point hinges on the developing recovery, which is too weak to provide scope for the Fed to truly tighten its policy.

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Market Yields

	3/18/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	10.50%	10.50%	16.50%
Effective since	2/28/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	12.00
Federal Funds	8.63	8.25	14.88
Repurchase Agreements	8.63	8.38	14.50
U.S. Treasury Issues			
Bills			
3 months	8.70	8.54	13.55
6 months	8.94	8.72	14.02
1 year	9.18	8.96	14.10
Coupons			
2 years	9.75	9.63	14.26
4 years	10.03	9.95	14.09
7 years	10.44	10.40	13.97
10 years	10.56	10.52	13.86
Long Bond	10.68	10.66	13.49
Negotiable Certificates of Deposit-Secondary Market			
1 month	8.70	8.55	14.40
3 months	8.80	8.65	14.50
6 months	9.00	8.70	14.55
1 year	9.20	9.15	14.55
Banker's Acceptances			
1 month	8.70	8.55	14.35
3 months	8.80	8.65	14.45
6 months	9.05	8.75	14.50
Eurodollar Deposits			
1 month	9.19	9.13	15.13
2 months	9.25	9.25	15.13
3 months	9.38	9.31	15.13
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	8.51	8.51	13.98
1 month	8.82	8.68	14.11
3 months	8.81	8.68	14.17
Bank Holding Companies			
1 month	8.30	8.30	14.37
Dealer Placed:			
3 months	8.80	8.66	14.99
New AA Corporate Utility Bond	11.95	11.90	16.13
Tax Exempt			
6 month Project Notes	4.60	4.40	7.50
1 year AAA Bond	5.10	4.75	8.00
5 year AAA Bond	6.00	6.00	9.25
20 year AAA Bond	8.50	8.50	12.10

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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